PROBLEMS OF SMALL BUSINESS CAUSED BY PRESENT TAX SYSTEM AND CREDIT FACILITIES AFTER WORLD WAR II

A THESIS

SUBMITTED TO THE FACULTY OF THE ATLANTA UNIVERSITY SCHOOL OF BUSINESS ADMINISTRATION IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

BY

PAUL LAURENCE HYDE

SCHOOL OF BUSINESS ADMINISTRATION

ATLANTA, GEORGIA

JUNE 1948

TABLE OF CONTENTS

PART ONE

PART TWO

LIST OF TABLES

LIST OF CHARTS

CHAPTER I

INTRODUCTION TO THE PROBLEM

Among the most serious problems encountered by small businessmen are those problems which accrue directly from the current revenue system of taxation and from the credit facilities that are available to small businesses. Inadequate capital and a relatively high tax rate are by no means the least important of the numerous causes that contribute to the failure of small businesses or to their high rate of turnover each year.

From the tiny seedling of small business our mightiest industrial giants have emerged. Small organizations are a primary source of initiative and new ideas, energetically striving to meet new needs and forcing alertness on all the rest of the industrial and distributive system. It is the basis for democracy in industry, providing alternatives through which independently minded men can escape from economic autocracy.

It may be said that small business is a necessity upon which the life of the free enterprise system depends. Opportunity and competition are the symbols of health in our economy - the works by which a man evaluates both his chance to rise to a position of prominence and his ability to obtain on an equitable basis the things his family needs. Where there is no room for new enterprise,there is no room for free enterprise.

There can be no more conclusive demonstration of opportunity in our economy than an increasing number of small businesses thriving in an environment of economic expansion. And there is no more effective means of combating the evils of monopoly than the promotion of new, small enterprises whose primary interest is to innovate, compete, and expand, rather than to restrict production and to protect a vested interest.

The roots of small business are firmly imbedded in the historic tradition of these United States. There are no alarming indications that this picture will be altered. Small business has become a tremendous social and economic force. As small businesses have grown and moved about freely without any uneconomic hindrances in our economy so has moved the American standard of living. The growth and expansion of small units can definitely be correlated with our increasing standard of living.

Census data on small establishments.- Table 1 indicates the relative importance in 1939 of establishments which are small businesses according to the composite definition of the Department of Commerce. These are manufacturing establishments with fewer than one hundered employees, wholesale establishments with annual sales or receipts less than $200,000, and retail and other establishments with annual sales or receipts of less than $50,000. In 1939, approximately nine-tenths or more of the establishments in each of the industry groups shown in Table 1 except wholesale trade were small. In all seven industrial groups, small business employed more than forty per cent of workers and active proprietors and accounted for more than one-third of the value of output on sales. Small businesses were most important in retail trade and service, but their employment and out put were a substantial portion of the total in all of the industrial groups shown.

This data points up the importance of small businesses in selected industrial lines with reference to their share of the volume of sales and the percentage of total employment in the total industrial economy.

Precarious Position of Small Business

This study is just one of many being conducted throughout these United States subsequent to World War II. It might appear that much concern is being shown to small business. It might also appear to the layman that this concern is unwarranted. This is not true. There are definite symptoms that all is not well with small business in our country.

Twentieth century business is properly based on competition expressed in efficiency of management, the ingenuity of enterprisers, the act of salesmanship, the mastery of technical skills, and the richness of promotional ideas. When the struggle for survival in the market place is confined to these areas of competition then there is no need to worry about the fate of small business.

Developments of the last several decades have strengthened the monopolistic practices of economic giants in an ever increasing area of American business. The rate of such development is alarming.

Powerful segments of the business community seek to preserve their favored positions through the use of non-business methods, by influencing governments, by combining to control foreign and domestic markets, by withholding scientific knowledge and practices from general use by obtaining special privileges as a means of defeating competition.

Before the tribunals of government determing important public policies affecting economic enterprise, powerful business can plead its case in the manner most likely to win, while the many thousands of little units scattered over the land have neither the funds, the time, nor the qualified pleaders to represent them successfully in the nation's capitol.

Statistics will show that four years prior to World War II there was a one-sixth decrease in all businesses with a preponderance of this decrease in the area of small business. It can be likewise shown that by the uneveness of their earnings the small business structure suffered more from taxation than did the larger enterprise with its more stable earnings. Likewise the cash position of the many thousands of small businesses is not as strong as that of the "big fellows." These statements will be supported later by current statistical tables taken from reliable sources.

The period from 1936 to 1937 was stated by Congress as being a fairly prosperous period for business in general.[1] From figures compiled by the Bureau of Internal Revenue in its annual report, "Statistics of Income", 1942, which contains many vitally important figures concerning the conditions of business, it was revealsed that from 1930 to 1939 approximately 64-9 per cent of all corporations show no net income. From another study it was revealed that from 1936 to 1939 approximately 59.9 per cent of all corporations also show no net income from their operations.[2]

Examining the "Statistics of Income" report by the Bureau of Internal Revenue it was revealed further that in 1942 for 442,655 corporations the gross income was twenty-three billion dollars. Of this sum 95.4 per cent was gathered in by 4.5 per cent of all the corporations. The remaining 95.5 per cent of the corporations received only 6.6 per cent of the total

---

1 What About Small Business? - A statement presented to the House Ways and Means Committee by the National Tool and Die Manufacturers Association in Cooperation with other Tool and Die Manufacturers, 1943.

2 See Table 2 in Appendix.

net income and less than this was theirs after taxes were deducted. Small business in 1942 constituted 2.5 per cent of our industrial system.

From Table 3 in the appendix section an attempt is made to show the cash position of a majority of the corporations examined by the Bureau of Internal Revenue. It can be easily seen that small businesses did not have as strong a position financially as large business in the year of the study, (1942). Their per cent of net income after taxes was only five percent as compared to the 2.9 per cent of net income retained by large businesses after taxes had been deducted.

Definition

"Small business," as with other concepts which are universally understood and accepted in American thinking, eludes precise definition. Yet, whether measured in terms of sales, number of employees, assets, or types of management operation, people easily distinguish between small and large business. To them small business means a particular combination of social values, a pattern of civic life, a growing free society, a healthy competitive business community.[1] It is the small businessman, the individual enterpriser, the owner-operator who has become so closely identified with the many hundreds of villages and cities of this land that he is the very foundation of the home town's growth and development. He, it is who starts from "scratch" to establish a business, borrow and puts money into the local bank, develops the know-how and does the pioneering which generates so many of the plans upon which our phenomenal industrial structure has been

---

1 Progress Report of Senate Small Business Committee, 1945, 79th Congress, 1st Session, p. 2.

reared, employs his fellow townsman, supports the schools, churches, and civic institutions. The whole community traditionally is stamped for good or ill by its small businessmen - the town takes its character from their enterprise, thrift, and civic mindedness.

Small business has ever been the seedbed of economic growth. Nurtured by competition and stimulated by the prospect of some measure of wealth and comforts to small business, it has fostered new developments, inventions, organizations, advancements which have added greatly to the volume and range of goods and services.

Various other definitions as to what constitutes small business may be of some value here. At least a broader base as to what is the general conception can be gained. Statistical definitions of what is a small business include roughly 90 to 95 per cent of all businesses in the United States. These definitions, whether based on the number of employees, gross sales,dollar values of assets, or net income, are substantially equivalent to the criterion which defines a small business as one in which the management decisions are made by one or two persons. The business may be proprietorship, partnership, or a corporation, but the existence of only one or two management persons is the essential factor of its smallness. However, for the purposes of this study, the statistical definition that points up 90 to 95 per cent of all businesses as being small and/or those units of business whose net income does not exceed 50,000 dollars except in those industrial lines where 200,000 dollars or less of net sales is used as a measure of smallness.

This study of the outstanding problems of our present tax system and the use made of our credit facilities will seek to show that the position of small business is burdened more than that of large business.

CHAPTER II

FINANCING SMALL BUSINESS

All business, both large and small, must grow in order to enjoy a healthy economic life. Economic survival is related to ability to grow and to adapt to the ever changing environment. Most businesses grow in part from within through the retention of earnings, but due to their financial situations small businesses must grow principally from without. Outside capital has not been available on favorable terms or in adequate amounts. For this reason the ability of small business to expand is limited.

The financing of big business in America is, in general, well organized whereas the financing of small business is nearly as haphazard a process as it was a century ago. The great corporation has its statisticians and its financial advisors. About all the little manufacturers can do is to subscribe to an advisory service, read newspapers and consult his bankers. The big company has a labor relations staff, with perhaps time study men, psychologists, welfare workers and labor lawyers. The small business man may have to be all of these himself.

A number of careful surveys have indicated that small businessmen are having an increasingly difficult time meeting their credit and capital needs from primary and secondary sources.[1] This is not a new problem, hence, our approach to alleviating the difficulties that small businesses are experiencing will be merely an extension of sound observations and findings already in existence.

---

1 "Credit Sources for Small Business," Department of Commerce, 1945.

Since 1929 a question repeatedly raised is whether the operations of the credit structure has not discriminated against small firms as compared with large firms, and whether small business, in view of its difficulty in obtaining financing, has not been unfairly handicapped in the competitive struggle. Specifically, it has been charged that small loans, i. e., loans to small undertakings, have been unduly costly to the borrow.[1] Such loans, irrespective of their cost, have been difficult to obtain, even by businesses that merited accommodations.[2]

Numerous investigations of this situation have been made by individuals, reserarch organizations, and governmental bodies. The subject is one of the most controversial in the field of finance, and conclusive evidence is difficult to obtain. We cannot attempt here to sift all the available arguments but certain observations are pertinent.

To begin with, special risks attend loans to small business that do not attach to credits granted to large concerns. This circumstance not only serves to make bankers cautious when lending to small businesses but also tends to make the terms of these credits onerous to borrowers. The risks inherent in small business loans vary considerable, with differing lines of activity and thus a single unified policy for this type of accommodation is difficult if not impossible to develop. The expense involved in investigating small firms, in working out the details of the financing arrangements for them,a dn in servicing such loans is often

---

[1] See Table 4, Appendix.

[2] Abbot, Charles C. Financing Business During the Transition (New York, 1946), p. 50.

disproportionately high when compared with the gross return. Consequently, the banks net return is apt to be unattractive.[1]

In the second place, many small concerns do not need bank credit so much as they need additional equity, under such circumstances liberal bank accommodation is not a remedy for the borrower's problem. Lenient credit may, in fact, increase his difficulties.

In a number of cases where credit apparently was justified the type needed was of an intermediate or long term character rather than "one-turnover" loans. But, as has been indicated, this is the very type of credit that has not been common among smaller banks. Since they typically do most of the financing for small businesses, this circumstance has tended to create the appearance of a shortage of credit.

Further, almost every investigation has pointed to some unsatisfied demand for credit from concerns that superficially, at least, appeared to merit accommodation. For example, Viner and Hardy concluded:

> There exists a genuine unsatisfied demand for credit on the part of solvent borrowers, many of whom could make economically sound use of working capital. Nevertheless, the total amount of this unsatisfied demand for credit is considerably smaller than is properly believed.[2]

In 1934, the Department of Commerce queried a sample of manufacturers who employed more than thirty but fewer than 190 wage earners. Of the firms

---

1 *Ibid.*, 79.

2 Viner, Jacob and Hardy, Charles O., "Summary of Findings as to Facts," Report on the Availability of Bank Credit in the Seventh Federal Reserve District, Washington, D.C., 1935, p. 6.

replying, 71 per cent or 4,387 normally borrowed some of their working capital. Of this number, forty-five per cent, reported difficulty in borrowing. The conclusions relating to the credit worthiness of these firms are the most significant in this report.

Conclusions.- Of the 1,964 fims reporting credit difficulty, no less than 450 or twenty-three per cent, claimed current ratios of 3.0 or over; and 818, or forty-two per cent, reported current ratios of 2.0 or more. Furthermore, 644, or thirty-three per cent, of these firms claimed net-worth-to- debt ratios of 3.0 or more; and fifty per cent of such establishments had ratios of 2.0 or more. Again, eighteen per cent of the firms reporting credit difficulty claimed both current ratios and net-worth-to debt ratios of 3.0 or more, and thirty-three per cent reported ratios as high as 2.0.[1]

A check of Dun and Bradstreet ratings for 620 firms that experienced difficulty, although they had both favorable current ratios and net-worth-to debt ratios, showed that almost two0thirds of these firms might be considered acceptable credit risks on the basis not only of their reported financial condition but also of their credit worthiness as judged by efficiency of mangement and by willingness to pay obligations at maturity.[2]

If the current ratio and net-worth-to debt ratios, coupled with favorable Dun and Bradstreet ratings, are indicative of the soundness of credit risks, it would appear that at least twenty per cent of the manufacturers reporting credit difficulties were eligible borrowers. This qualification is made because the above mentioned ratios are not indicative

---

1 Survey of Reports of Credit and Credit Difficulties, Department of Commerce, Washington, D. C. 1935, pp. 2-3.

2 Ibid., p. 3.

of soundness of credit risk in all businesses.

These findings substantiate the belief that while there is not a lack of known and accepted financial devices, the knowledge of these techniques, and more especially their employment, have not been so widespread as to leave the complaints of the spokesmen for small business without foundation.

The findings on this point may be summarized as follows: Credit accommodation for small business is now more generally recognized as a special problem than was the case a few years ago. Numerous investigations, the recent activities of the Senate Subcommittee to study problems of American small business, the operation of the Reconstruction Finance Corporation and the Smaller War Plants Corporation, and the experience of the Federal Reserve Banks with 13B loans, have not been without effect. The commercial banking fraternity itself exhibits a greater awareness of the problem. If the efforts of the numerous banking groups studying the situation result in a growth of initiative and a real interchange of "know how" among the bank officials in a community, thereby increasing in a significant way the lending abilities of local groups of banks, the credit problem of small business will be much nearer a solution. If we admit that lending resources of financial institutions in a technical senses are ample, but that special needs of business have nevertheless not been met, what then is required, in a large sense, is greater mobility in the flow of credit to business. By mobility is meant a wider use among bankers of all accepted financing techniques, and increase in the types of financial arrangements offered to customers by particular banks and a more widespread interest among bankers in finding ways to make, on a sound basis, loans of unfamilar types.

Whether this mobility is achieved will depend on the development of more initiative and imagination among bankers, a lesser dependence on banking traditions of outworn usefulness, and, perhaps, a downward revision in the tax liability of banks, so that the "marginal" loan, on which the net profit is doubtful, will appear more attractive. In the last analysis, attainment of greater mobility will be governed by the mental attitudes and flexibility of loan officers - and, perhaps, by some modifications of the legal credit structure within which they work.

The following sections within this chapter will be devoted to viewing the accepted financial devices and the part they play within the credit structure.

Most important source of credit.- Commercial banks generally have furnished the greater portion of short-term and intermediate term credit to small enterprises. Recently, other sources have come into the picture in an appreciable manner. We may be on the threshold of great changes in the national credit structure, and we may presently see other institutions supplant commercial banks as the major source of business credit. Regardless of other sources commercial banks still dominate in the field of lending activity. Consideration of the types and availability of short and intermediate term funds must focus principally upon the availability of bank credit.

The phrase, "availability of bank credit," is subject to a number of interpretations. It will be discussed here with reference to the sufficiency of the legal reserves and the capital funds of banks; the number, variety and flexibility of short-term financing arrangements known and commonly utilized and the ability of business concerns, particularly small and medium-size firms, to make use of these arrangements; the legal restrictions and regulations governing the operation of commercial banks and regulations controlling the lending operations of other types of institutions.[1]

Legal reserves and capital funds.- Table 5, appendix section, shows the trend of excess reserves of member banks and the ratio of the capital accounts of insured commercial banks to total assets and to "earning assets at risk" - loans, discounts, and securities other than Federal obligations. Despite reductions in the reserves requirement of central reserve city banks after 1941, excess reserves continued to fall rapidly after 1940, as did the ratio of capital funds to assets at risk. The ratio of capital funds to assets at risk, however fluctuated within a range of 24.0 to 30.2.

There is little to indicate that the drop in excess reserves during the war exercised a restrictive influence upon the bank lending policies. In the absence of a credit expansion that the governing authorities considered unsound, a further decline in excess reserves is not likely to be a restraining element during the transition period.

This conclusion is supported by such counteracting factors as the ability of banks to fortify their reserves by borrowing from the Federal Reserve Banks, the large volume of commercial banks assets eligible and acceptable for rediscount, the present arrangements under which the commercial banks sell Treasury bills to or purchase them from the Federal

---

1 Abbott, Charles C., op. cit., p. 73.

Reserve Banks, and the powers possessed by the Board of Governors to alter the reserve requirements of member banks.

The decline in recent years of the ratio of commercial banks capital funds total assets reflect their wartime acquisition of very large quantities of Federal obligations. It is probable that this growth in holding of government bonds will continue for sometime after the war and a further shrinkage in the ratio of capital funds to earning assets - and deposits may be anticipated.

In veiw of the tremendous credit needs of expanding business economy the question is not so much whether a bank has enough capital for the type of assets which it holds, rather, will this ratio of capital funds to total assets enable these commercial banks to assume the proper and reasonable risks of participating in the financing of business enterprise. Table 5, appendix section, clearly points out the decline in the ratio of capital funds to total assets for the commercial banking community.

Legal restrictions and regulations.- Since 1943, demand deposits, excluding United States Government and inter-bank deposits, have been backed more than dollar for dollar by Federal obligations, and there appears to be no immediate likelihood that this coverage will decline. The probability lies in the other direction - that Treasury securities held by the commercial banking system will grow relative to deposits. As has been remarked in other connections: ...'the character of banking has drastically altered.for the war accelerated a trend that has prevailed since the last war."[1]

---

[1] Whillesey, Charles R.,"Bank Liquidity and The War," National Bureau of Economic Research, (New York, 1945), pp. 85-86.

Banks have now become chiefly custodians of federal debt instead of being concerned mainly with furnishing working capital for commerce and industry.

As a consequence of the war, several questions have been insistently posed by the changed position of the commercial banking structure; what shall be the function of the commercial banking structure in the economy? Shall banks in the future serve chiefly as depositories and transferers of the public money? Shall their main function be that of ultimate purchases of federal deficits and custodian of the federal debt?, or shall they continue their traditional function of taking calculated risks at a fair price for profits, and if so, shall they develop types of loans and earnings assets not now generally considered "bankable?" Public policy must find answers to these questions. When this policy has been determined, it will be time to review the philosophy and mechanisms of bank supervision and to reconsider what proportions of different types of earning assets are acceptable, what methods should be employed in appraising individual assets, the liquidity needs of particular banks and the reserve policies pursued by them. One important question that public authority will need to face squarely is: which aspects of bank operation are now properly subject to supervision, and which should be left to managerial direction? There are significant limits to what bank examinations, as a tool of policy, can accomplish. It cannot assure forward looking, enterprising, and constructive management. While bank supervision can and does serve to restrain of loans and investments.[1]

---

[1] Leonard, R. F., "Supervision of the Commercial Banking System," Banking Studies (New York, 1946), p. 209.

The legal framework within which credit operations are conducted is at least as important in appraising the availability of credit as is technical lending capacity or the number of accepted borrowing devices. Commercial banking operations are governed by an extensive and somewhat complicated body of statutory provisions and regulations, rules, licenses, and instructions issuing, as the case may be, from the comptroller of the currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the United States Treasury, in some cases the Securities and Exchange Commission, and the Banking authorities of the several states. In general, statutory provisions express broad public policy. The rules and regulations issued by governmental authorities implement policy. The actual effect of statutory provisions, however, is largely determined by the nature of their administration.

The principal administrative activity affecting bank operation is the bank examination, and for examination purposes banks fall into four categories - National banks, state member banks, non-member banks, and non-member non-insured banks. There are three federal and forty-eight state examining authorities. Except for non-member banks, every commercial bank is subject of at least two examining authorities. Although by agreement of June 1938, the three federal authorities established a uniform treatment for loans and investments, as has been pertinently observed, there is no one supervisory authority to decide matters of policy with respect to the supervision and examination of all banks.

Commercial banks - credit techniques.- The traditional function of commercial banks is to take risks at a fair price for profit, with the aim of building up their communities. If banks abandon this function (trend is toward depository of Public Debt), unquestionably, other institutions will and should grow up to fill the needs of the economy. The extent to which banks continue to confine their investments to so called "riskless assets" business and agriculture in the post-war future will have to obtain their accommodation elsewhere, either from competing credit institutions or from government agencies.[1]

The following types of loans should be available from commercial banks, although no one bank makes all of these loans.

Character loan: This is a loan without collateral and is based upon the applicant's production and sales ability, earning capacity, business standing and general integrity.

Term loan: This is a loan that may be defined as one to a business enterprise that is repayable, according to an agreement between lender and borrower after a period of more than one year. The maturity period of a term loan averages around five years, although, sometimes it runs up to ten or fifteen years. Term loans are frequently unsecured, yet interest rates are generally low. They are frequently designed to be paid out of earnings. An analysis of this type of loan is on page .

Installment loan: This is a loan that is repayable in monthly installments. Such loans are usually from $100.00 or less to $1000.00, though some of them go up to $2000.00 or $3000.00. Interest rates on bank installment loans are relatively high. It commonly ranges from seven per cent to as much as twenty per cent.

---

[1] Annual Report of the Federal Deposit Insurance Corporation for the year ending, December 31, 1942, p. 5.

Loans on accounts receivable: These are defined as loans secured by the pledge of accounts or notes receivable. They are either on a notification or a non-notification basis.

Loans secured by warehouse and field warehouse receipts: These are defined as loans secured by a receipt issued to acknowledge ownership of a properly stored stock of readily salable goods.

Equipment loans: These are similar to the one above except that the security is of a more durable nature. These loans often run from two to three years, or longer in the case of heavy equipment.

There are other types of bank loans but materially the only difference lies in the type of security offered. Example, the chattel mortgage loan which is a loan secured by an assignment of title covering something owned by the debtor. It differs from equipment loans only to the extent that it is a different legal device and ownership of property used as a security is all ready present.

Whether the various financing techniques are as widely understood by commercial banks and are as commonly employed as they could be is open to question. However, it has been revealed that only one out of four banks in 1941 utilized term loans, although approximately four out of five with deposits of ten million dollars extended credits of this type.[1] Furthermore, no more than one out of four commercial banks was active in accounts receivable financing.[2] And, in the same year loans against field warehouse

---

1 Jacoby, Neal H., and Saulnier, Raymond J., Term Lending to Business, (New York, 1943), p. 33.

2 Jacoby, Neal H., and Saulnier, Raymond J., Accounts Receivable, Nation Bureau of Economic Research, (New York, 1943), p. 4.

receipts were extended by only thirteen per cent of insured commercial banks. Personal loans have been slow in gaining acceptance among commercial banks and many do not offer this service.

<u>Other private sources</u>: Trust companies and Bank Trust Departments are frequently able to make the above mentioned types of loans. This ability to lend depends upon the stipulation of the particular trust plus the discretion of trust officers in acting under the trust.

<u>Bank credit groups</u>: These are called groups because of the fact that they do not set up their resviors of credit in advance of a situation but only as it arises. This technique serves to negate the inability of one bank to meet a credit situation. This technique is not yet too prevalent. The American Bankers Association is the sponsor of this program by which greater facility of lending techniques can be made available to small business.

<u>Industrial banking companies</u>: An industrial bank is one that specializes in consumer installment loans and gets its working capital at least partly from customer deposits, the sale of small denomination investment certificates, or both. These banks have continued to stress financing of the consumer, but their relative volume of business loans has been increasing in recent years. This type of loan for business purposes is relatively an expensive form of credit because the effective per annuam interest charge is almost double the stated rate of discount, or typically twelve to fifteen per cent or more.

<u>Small loan companies</u>: These companies make some of the kinds of loans that industrial banks and commercial bank installment departments make. But generally, they are limited by law to making smaller loans, usually $300.00

or less. Their interest rates usually range in the prohibitive area between twenty-four per cent or forty-two per cent.

Factors: Factoring companies are concerns which specialize in buying outright the receivable accounts of their clients. They usually advance funds on a short-term basis, with time of conversion ranging between thirty and sixty days. Most of them operate on a notification basis which is highly undesirable. They are also poorly distributed in this country at the present time. Interest rates are now commonly only five or six per cent per annum, depending upon the turnover of receivables.

Sales finance companies: These companies specialize in buying installment receivables at a discount. Their charges vary greatly and generally are expensive.

Insurance companies: They often make mortgage loans on industrial properties as well as on residential and commercial properties. Most of their loans go to large business concerns who want $100,000 or better.

Trade credit sources: This source of credit is highly important to the retail trade. Wholesalers and other suppliers usually furnish this type of credit in order to facilitate the movements of goods.

Individual investors: This term is self explanatory. This individual is still a potential source of funds in so far as there are not too many stringent forces reducing the surplus amount he might have available for investment purposes.

Investment bankers: It is generally not an easy matter for the small business to secure funds by selling securities as the cost of floating and selling a small issue is very costly. However, if found feasible, it is through the investment banker that equity funds are generally secured.

Corporations seeking affiliates and cooperative groups of small businesses are additional sources of funds. Their part in making available funds to small business is minor with particular reference to the total credit structure.

Public sources: The function and position in the exonomy of existing government lending agencies and their relation to private lending agencies are in numerous respect obscure. For instance, in certain types of financial institutions they compete with each other as well as with private financial institutions. In other situations they supplement rather than compete with private organizations.

The type purpose, and the amount of credit extended by the several agencies are defined by the pertinent statutory provisions and legal interpretations thereof.

Access to funds from the capital markets: The success of small as well as large businesses is dependent in no small degree upon the volume of funds readily secured from the investment markets, namely, security markets, bond, institutiona, new issue, or over the counter sources.

These markets will be discussed in a broad sense since they are closely interrelated and are influenced by the same forces; developments in one affect the course of others and to a considerable degree the several markets compete for business. It will be easier to calculate the flow of funds into small businesses when these credit sources are viewed as an entity.

It has been pointed out by the June, 1945, issue of the Federal Reserve Bulletin that liquid asset holdings of individuals and institutions, as expanded by the wartime economy, plus the current supply of new savings will be adequate and conceivably more than adequate for the overall needs of business during this period of our economy. This did not mean, however, that all tupes of investment funds would be in ample supply.

Although investable funds have been in plentiful supply, they have probably not satisfied the aggregate needs of all kinds of business for financing, since the quantitatively dominant types of investment funds have often sought types of securities that business concerns in general either were not in a position to offer, or did not wish to sell. Equities and the issues of small or newly organized companies have not been offered because buyers have not existed for these kinds of securities. Thus, an imbalance has apparently existed between the types of securities that business could or would sell and the kinds that could in fact, be sold.

A supply of savings can, in theory, be sufficient to meet the needs of the business economy, and still, in actuality, leave various types of demand unsatisfied because of inflexible and immobile investment procedures. This is true today, with reference to the securing of equity or long term capital for small enterprises. Specifically, the supply of funds seeking high grade liquid investments of a preferred character in large concerns has been greater than the demand, while the amount of money willing to take junior position or to go into a relatively small new or unlisted enterprise - in short - to venture - appears to have been well below the demand.

A member of the Securities Commission pointed out in a deft fashion the role Wall Street plays in reference to small enterprises.

Small business constitutes a good one-third (conservative) of our commerce and industry. It is disturbing to realize that so far as this large segement is concerned, capital is practically unavailable and credit is only slightly more accessible. Wall Street's function in the investment field is the handling of those securities that are suitable for national distribution. The securities of small and middlesized companies are not in this class.

Within the local market or community the small enterprises fares little better even though this is the natural source and in many instances the only source. It should be pointed out here that local underwriting, as a continuing and effective process, practically does not exist. There are no financial institutions which are actively engaged in raising long term funds in small quantities. The prevailing methods of syndicating and distributing securities are not well adapted to the merchandising of issues offered by relatively small and obscure companies. The cost of floating such issues is oftime prohibitively high, amounting at times to twenty per cent or even more of the funds sought.

Reason why credit is needed: Small firms will need funds for two main purposes. In the first place, they will need capital funds for the acquisition of fixed assets, and also, they will need funds for working capital purposes. Business expenditures for new plant and equipment during 1946-47 were nearly three times as great as in the pre war years 1939-40.[1]

The impact of post war forces upon our economy have surely created tremendous credit needs for that segment of our industrial world that is made up of small businesses. That businesses of all sizes are in the process of reconstructing a pattern of assets and business organizations suitable to these dynamic peact time conditions is an inscrutable fact.

The financial problem facing particular firms will differ radically.

---

1 Federal Reserve Bulletin, April 1948, p. 386.

In some lines it will be met simply. In other lines it will be one of major proportions. Nothing specific can be said as to the actual amount of credit that is needed to finance small businesses through this transition period but it is hoped that a fairly good estimate will be pointed up within the next few paragraphs.

Competent observers generally agree that in the decade before the war serious obstacles confronted small firms seeking small amounts of capital. This was especially true when funds sought were either equity or of the term loan nature. Their belief now is that this problem is magnified. The present trend of certain factors have borne them out in this belief. The movement of prices upwardly has greatly increased the demands for financing since the dollar value of needed outlays is expanded. The length of the transition period also plays an important part in shaping up the demand for funds. It is good business policy to be in a high state of liquidity during these periods of dynamic flux. The removal of various controls which previously had obscured the outlook for civilian production and profitable operations has also enhanced the prospect that small firms will seek in an increased manner financial aid in order to maintain a profitable competitive status.

Because of the important position that small firms play in our economy, the assurance that adequate credit facilities will be available to them is greatly needed. This is now more generally recognized than it was prior to the war period.

According to Federal Reserve authorities, the basis need of the smaller, independently, owned business enterprise is for long term funds. Some businesses need funds for modernization of plant and equipment and additional facilities. The need also arises from the sharp increase in prices and greatly expanded volume of business resulting in a much larger volume of accounts receivable and of inventories. Because of these various factors many enterprises whose financing needs have ordinarily been met through current borrowings now need a funding of their short term obligations into term loans.

It is difficult to evaluate fully the future reaction of small businesses to the increased availability of this loan technique, however,it can be pointed out that the necessary prescribed financial policies are most difficult for small businesses. Requirements such as these must be presented to the lending institution before a term loan can be granted - an estimate of future earning power, ability to meet scheduled payments, ability to meet a prudent level of liquidity for operating purposes, continuity of management, existing and future competitive position within the industry, and assurance that assets will not be pledged to the detriment of the term loan creditor.

The importance of the large business enterprises in the dollar volume of bank term lending is shown in Table 7, appendix section which indicates that two-thirds of the amount of all term loans outstanding on the date of the survey were to concerns with total assets of $5,000,000, or more. Within this group, manufacturing and mining companies and public utilities accounted for practically all of the term borrowing.

The term loan has become increasingly available to small and medium size enterprises, but only to highly rated enterprises. At the time of the survey, ninety-eight per cent of the member bank term loans represented advances to enterprises having assets less than $5,000.000. That the vast majority of term loans are extended to small business is further emphasized by the fact that enterprises having assets of less than $250,000, accounted for ninety per cent of the number of term loans outstanding or about 133,000. Although these loans amounted to no more than one-sixth of the dollar amount of term loans outstanding, the term loan is well established and accepted type of transaction for making credit available to small enterprises.

A brief glance at the total volume of loans outstanding as of November 20, 1946, according to a Federal Reserve Survey, reveals that thirty-four per cent of the amount was in the form of term loans which is approximately $4,487,000,000. Contrasting this figure against the total number of small business it was revealed that the average size of the outstanding term loans would be less than $300.00. This is highly inadequate in view of the long term credit needs of small enterprises.

Approximate number of Small Enterprises...3,000,000
Approximate size of average loan..........$255.00[1]

---

1 This interpolation is based on an analysis of a series of articles taken from the Federal Reserve Survey, November 20, 1946.

CHAPTER III

SUMMARY AND CONCLUSIONS

Small business concerns form a major portion of the business population (92.5), furnishing employment to approximately 44.8 per cent of the total working population and producing 34.1 per cent of total production.[1] This pattern has not changed significantly. Small business still forms approximately 92.5 per cent of the business population with its corresponding share of working population and production. Production in no-wise has reached the point where effective demand has been satisfied.

If we are to achieve within our economy a high level of employment, preferably between 54,000,000 and 60,000,000 people and if we are to bridge the gap existing now between effective demand and overall supply and if we are to reasonably satisfy the essentials for economic progress, namely,(a) the willingness of individuals to devote effort, imagination and capital to increased production, more efficient production and the production of new things, and (b) the supply of capital ready to move into the frontiers of economic development,[2] we must consider the following factors which have been pointed up and determine in what manner they should be alleviated in order to remove from the bosom of small businesses all uneconomic

---

1 Census of Business, 1939.

2 A Program for Prosperity in a Free Economy - A statement on National Policy, The Research and Policy Committee of the Committee for Economic Development, 1947, p. 13.

hindrances, all unfair coercive practices, and all unsound government restraints with reference to an adequate flow of funds into the small business area.

The rate of development of economic giants has been alarming within the last several decades. The monopolistic practices of these large businesses tends to stifle the necessary growth and competitive activity of small enterprices.

In 1942, small businesses, ninety-two per cent of all corporations, received only 6.6% of the gross income as reported by the 442,655 corporations that filed income statements with the Bureau of Internal Revenue. The percentage was less after taxes were paid. Also, during the last prewar period of normalcy, (1936-1939), 59.8% of these firms, (as revealed by a "Statistics of Income Report attached), showed no "net income". Thirty-five to forty per cent of these firms actually lost money on their operations.

Loans have been unduly costly and have been difficult to obtain, even by businesses that merited accommodation.[1]

Intermediate and long term loans have not been common among small banks. Small banks do the greatest portion of small business financing in one-turnover type of loans.

Small banks are limited in their attempts to more adequately utilize known and accepted lending techniques.

The impact of postwar forces has created tremendous credit needs in view of the fact that businesses of all sizes are in the process of

---

[1] See Table 4, Appendix.

reconstructing a pattern of assets and business organizations suitable to dynamic peacetime conditions.

The role of commercial banks-is it to be that of depository and transferer of public debt or is it to be within the area of their traditional function?

Small enterprises have very little access to funds from capital markets.

CHAPTER I

INTRODUCTION

Part Two

The primary interest of business, large business as well as small, is to achieve a post war economy of full employment and brisk demand. Only in a prosperous economy can business also be prosperous. It is well known, however, that small business suffers even more than big business from unemployment and prosperity. This is indicated clearly by Chart I, which shows unmistakably that the earnings of smaller manufacturing corporations are directly dependant upon the level of national income. Thus, a tax program for small business must be designed primarily with a view to its effect on total employment and demand. The gain to be realized from full employment far exceeds any possible advantage from special tax adjustments designed specifically in the interest of small business.

Underlying any discussion concerned with bringing relief to small enterprises by the alleviation of the pressure brought upon them by specific areas of the tax system, are the _budget_ reguirements of the government and the _attainment_ and _continued_ smooth _operation_ of the economy at high levels of _employment_, _production_, and _income_.

It is generally recognized that tax rates and tax burdens are too heavy throughout the Federal Tax System. Regardless of this truth bugeting requirements influenced strongly by world conditions preclude widespread tax

---

[1] "Corporate Earnings by Size of Firm", _Survey of Current Business_ (May 1945), p. 11.

reduction at the present time.

Hence, it will be exceedingly difficult to ask for relief for small businesses from the various points of the tax system that press upon them more so than upon large enterprises. Likewise, it will be exceedingly difficult to ask for specific relief without encountering perhaps too numerous problems involving equity and administrative problems. However, it is hoped that through an analysis of the points of pressure brought to bear upon small business more inequitably than upon large ones revision or reforms of the tax structure can be made easier.

The Federal government will continue to be the senior partner in every business or profession. It behooves us, therefore, to use our best brains on the tax system under which we must live and move and have our being. We must try to shape it so that, burdensome as it will be, it will still permit and indeed encourage American enterprises to flourish and function. The task, is not rosy in a complex and disordered civilization but it can be done if Congress and the people see the issues and meet them squarely.[1]

Everyone recognizes that taxes, particularly individual income taxes of the magnitude we have now and shall have throughout the foreseeable future play a major role in shaping business decisions. It follows that the impact of taxes upon our economy deserves careful study in order that our taxation policies may be shaped to serve the same governmental or economic ends that our other national policies do. This is not to say, however, that taxation should be directed primarily to enforce social or

---

1 Proceedings of the Academy of Political Science, Vol. XXII (May 1947), No. 3, p. 286.

economic policies deemed desirable at the moment. The primary <u>utility</u> of tax law is to raise money fairly to meet the expense of government. That is the target at which the shotgun of taxes should be aimed. It is a difficult target to hit, even with a shotgun. It is hard enough to draft laws that will raise billions of revenue fairly from all sorts and conditions of businessmen without undertaking at the same time, to accomplish desired social or economic ends.

Our fundamental premise is that the free private-enterprise system should be maintained. What makes it go? Primarily, the vigor and the enterprise and the competition of the men who manage it, especially the <u>owners</u> and <u>operators</u> of 92.5% of our business establishments. Do not forget that regardless of however great our corporations may become, they will be greatly dependent upont the broad base that is made up of small enterprises which furnish the necessary ingredients such as vitality, stimulation, training, competition etc., which are essential for our type of free enterprise economy.

Large corporations have an exceptional capacity for resisting deressions and adverse influences on earnings. This is not true of small firms. The earning power of small firms is only markedly improved when the economy moves toward the higher operating rate.

The industries which must expand during this readjustment period, if there is to be full employment are the very industries in which small firms are relatively important as shown in Chart II, such industries as construction, service, lumber, textiles and apparels, etc., with a high percentage of merchanized and integrated industries.

The impact of taxes on small businesses in these fields might seriously effect the aggregate amount of employment, particularly since the burden of given taxes may fall with greater weight upon smaller concerns than upon large ones. Therefore, the tax program when viewed as a part of full employment policy, must be planned with due regard for the special problems of small business.[1]

Special problems:

1. Under our existing financial institution, small businesses operate under serious disadvantages in securing capital. Traditionally, small enterprises have secured much capital from well-to-do individuals but for several reasons, not the least of which is taxation, this source has dwindled.

2. The earnings of small businesses tend to fluctuate from year to year, more than those of big businesses. This is because small businesses are less diversified in their operations and thus more affected by the ups-and-downs of business trends. As a result, taxes on small businesses earnings tend to be more severe than taxes for big businesses.

3. The taxation of income tends to increase the riskness of small businesses more than that of large. By means of the tax the Treasury stands ready to share any prospective gain, but not to share prospective losses. Thus, the tax has the effect of loading the dice against income from other sources. It is true that the present carry-over of losses mitigates this problem, but by no means removes it.

---

1 Smaller War Plants Corporation, Economic Report on Taxation (September 1945), pp 6-7.

4. Small companies usually operate under conditions of intense competition. They may specialize in a limited line of products for which the demand is variable and the market is restricted. Therefore, their control over price is so slight that they are seldom able to shift any substantial portion of the taxes levied on them, except possibly in the long run.

5. Small businesses, unable to afford legal and accounting advice, find difficulty in interpreting tax law and regulations.

6. Because of heavy corporate taxes, small businesses are forced or induced to adopt the proprietorship form of roganization, thus losing the benefits of the corporate form.

Federal taxation discourages risk taking and the growth of small businesses. It has become too complex and it imposes burdens which are more burdensome for small enterprises than large ones during this period of readjustment.

In order that small firms in all industrial lines may thrive and increase the income of the consumers, expand employment, and attract investment, tax planning is essential for these ends.

<u>Analysis of Tables 1 and 7, and Chart 2</u>: A thorough analysis of Table 1 and Chart II will reveal some startling information with reference to the effectiveness of those financial terms which have been made available to the industrial economy.

Table 1 reveals that manufacturing, retail trade, wholesale trade, construction, and service have the greatest percentages of volume of sales in the United States out put. Chart II reveals that the area of expansion and potential employment lie most favorably with the construction, trade, services, lumber and timber, mining, transportation and public utilities, and textile mill products industries, yet, according to Table 7, those industrials, manufacturing public utilities and mining, account for practically all of the term borrowing, or better still, term borrowing is extended to them more readily than to other lines.

Small companies predominate in those lines where loans are not so readily available. If the full employment feature of our economy is to be achieved it should be pointed out again, that those areas within which the greatest potentiality of expansion lies more attention should be shown in order that any inequitable or unfair burden can be removed as painlessly and expeditiously as possible.

CHAPTER II

PRESENT TAX SYSTEM AND BUDGETARY REQUIREMENTS

The various points at which the present tax system bears most heavily upon all businesses and inequitably upon small businesses have been accounted for by many expert observers.[1] These points will be enumerated later after the present tax system is characterized.

Present tax system: The three chief sources of federal revenue are the individual income tax, the corporate profits tax and the excise taxes.

The main source of revenue is the individual income tax. About 50,000,000 persons now pay individual income tases; in 1939, only 4,000.000 persons paid an individual income tax. The tax is at progressive rates on income in excess of personal exemptions and deductions. Exemptions of $500.00 for each tax payer and dependent are allowed. On the first $2000 of taxable income the rate is 19%; it rises to 50.35 per cent on income between $18,000 and $20,000 and reaches a maximum of 86.45 per cent on income in excess of $200,000.

Viewing these individual rates further, it can be noted that the impact of these tax rates upon the managers and the stockholders is inimical to the interest of our private-enterprise system. Once a man reaches an income of $18,000, or more, the United States Treasury is entitled to more than he is himself of every additional dollar he earns. Once this individual reaches an income of $44,000, the treasury takes more than sixty-eight

---

[1] See Taxes and the Budget, a statement on National Policy, Committee for Economic Development, (November 1947), p. 58. Also see, "A Tax Program for A Solvent America", The Committee on Postwar Tax Policy, 1947, pp. 6-8.

cents out of every additional dollar earned, leaving only thirty-two cents for individual effort. If this income is increased to $70,000, the treasury takes more than seventy-seven cents out of every additional dollar earned, leaving only twenty-three cents as compensation for individual effort.

Can it be believed that surtax rates of this sort are more likely to induce men to take on more responsibilities, or to persuad them to take take a rest?

It may be said that most individuals do not enjoy such salaries, but are not the managers of small American enterprises typically those with incomes of these amounts or more? An $18,000 salary at the present time is not notably high, and many men, well below the top rank of American executives receive that and more.

The standard rate of corporate profits tax is thirty-eight per cent, and applies to the net earnings of all corporations that earn $50,000 or more in any year. Corporations with smaller profits pay at lower rates on the first $25,000, ranging between $25,000 and $50,000 are taxes at fifty-three per cent to make the total tax thirty-eight per cent on the first $50,000.

The corporations with small net incomes pay less than the standard rate under existing law. But this advantage inures to them only while they have a small income. The number of companies with net incomes under $50,000 far exceeds the number of those with incomes above this amount.[1]

---

1 See Table 6, Appendix.

This will always be the case, regardless of taxes imposed. But the growth of the economy is dependent, in part, upon the ability of any group of corporate managers to expand the scope of operations and to develop the productive capacity which will bring to them and their shareholders a larger volume of income than $50,000. The present tax is a serious barrier to that expansion.

Excise taxes are now imposed upon the sale of over fifty groups of goods and services, at either the manufacturing or retail level. The largest revenue producers are alcoholic beverages, tobacco and gasoline.

The following table will show more vividly the role of the above three sources and that of others in the lastest budget estimate.

CASH RECEIPTS FROM THE PUBLIC[1]
(Year ending June 30,1948)

Individual Income Tax	$20.5	billions
Corporate Profits Tax	8.5	"
Excise Taxes	7.2	"
Employment Taxes	3.5	"
Estate and Gift Taxes	.7	"
Customs	.5	"
Trust Accounts	1.0	"
Miscellaneous Receipts	3.4	"
Total	$47.3	billions

At this point it should be quite clear that the present congress is not interested in any tax revision, i. e., there will not likely be any revisionary laws passed during the eightieth session. Reductions only in the individual income area are the only ones being considered with a better

1 Taxes and Budget, op. cit., p. 40.

than average chance of passing over a presidential veto.

This has to be in the light of present budget requirements. Expenditures are estimated to be (1948-1949) $39.7 billion and are likely to be higher if present world conditions do not become mitigated by more peaceful overtures.

The transition period through which our industrial economy is now passing is characterized by factors which give rise to grave concern and almost preclude reductions and revisions of any nature.

We are now experiencing an era of unparalleled prosperity but we have not witnessed any contribution to debt reduction from the three postwar years. This should be a demonstrable fact that federal spending is a difficult factor to reduce or curtail even in periods of unprecendented prosperity. It should also be revealingly clear that the above fact points out the weakness in schemes for cyclical budget balance. The president's budget for 1948-49 is the first to show a surplus and it is in such a precarious position that it can not safely be regarded as a contribution toward debt reduction.

In viewing the whole tax system with reference to capital flow, the number and the scope of changes in tax laws in recent years and the character of tax administration appear almost as important as the form of the structure itself. In planning for an accelerated rate of peacetime investment precise attention should be given to methods of creating in the minds of businessmen and investors the expectation that stability in the tax structure will be greater and tax administration more consistent than has been the case in recent years. These considerations are of special importance at the present time, when we are faced with constructing a long range tax program.

CHAPTER III

ANALYSIS OF POINTS OF THE TAX STRUCTURE THAT PRESS HEAVILY UPON SMALL BUSINESS

It is generally agreed by most tax experts that the problems created by the pressure the tax system brings to bear upon small business can be classified into two groups:

1. Rates in the notch area of the corporate profits tax are too burdensome. Rates on net income are too heavy.

2. Existence of differentials of taxes on incorporated and unincorporated business.

These problems can further be broken down into sub-classes:

1. Graduation of corporate income tax rates are too limited; modification of Section 102 - surtax on corporations, improperly accumulating surplus needed; loss offsets and depreciation.

2. Double taxation on retained and distributed earnings.[1]

Rates on corporate and individual income are too high: At the present time rate graduation in the corporate tax is restricted to corporations with net incomes of less than $50,000.[2] For corporations with net incomes in excess of $50,000, the tax rate is thirty-eight per cent of the entire net income. For corporations with net income of less than $25,000, the following three bracket rates are provided; on the first $5,000 of net

---

1 "Taxation of Small Business", Treasury Department (Washington, D. C., October 1947), p. 5.

2 *Ibid.*, p ii.

income, twenty-one per cent; on the next $15,000, twenty-three per cent; on the next $5,000, twenty-five per cent. On net income in the so-called "notch area", ($25,000 to $50,000) the rate is fifty-three per cent. The notch area is justified on the basis that a corporation would find that an increase in its net income from $50,000 to slightly more would actually decrease its profits after taxes. Too, this is in line with the general rule that the tax on net income of $50,000 is thirty-eight per cent.

Although any limited graduation system necessarily requires a notch rate higher than the standard rate, flexibility in the notch rate may be obtained by varying the width of the notch area. The wider the notch area, the less the notch rate needs to exceed the standard rate. For example, if the notch area were extended to cover net income between $25,000 and $75,000 instead of the present $25,000 to $50,000 area and rates were otherwise unchanged, the present notch rate could be reduced to forty-three per cent. This would immeasurably aid the bulk of small corporations since the greater portion of them have income of less than $50,000.

Graduation of corporation income tax rates is a well established practice, although its basic justification is open to question. Graduation can offer a tax advantage to small corporations but it raises certain economic and equity questions, especially to taxation of fluctuating incomes.

Limited or full graduation may be achieved by means of graduated bracket rates, graduated effective rates, but the latter have the advantage of not calling attention to high rates imposed on an addition to income. Graduation by means of an exemption is relatively inflexible, and the starting rate must be zero. Moreover, an exemption under corporate tax raise an equity problem of possible unfair discrimination against unincorportated enterprises.

Section 102 of the Internal Revenue Commission needs modification: It has been complained that the surtax imposed under Section 102 of the Revenue Code on corporations improperly accumulating surplus is a deterrent to the growth of small corporations, which have more to fear from the application of it than widely held corporations. The fear of its application keeps many small corporations from retaining an adequate portion of their earnings to finance expansion and for contingencies.[1]

The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is held to be the determinative of the purpose to avoid surtax on the stockholders, unless the corporation can prove the contrary by a clear preponderance of evidence.

However, any exemption granted under Section 102 would open the way for flagrant tax postponements and avoidances. The language of 102 or its record of past application do not give a substantial basis for the fear which surrounds it.

Loss off-sets: The chief economic purpose of loss off-sets is to reduce tax impediments to the incentive for taking business risks. If loss-off-sets are not allowed, the tax system will reduce possible returns from risky investments but will not on losses from unsuccesful investments. This will have a tendency toward one of conservation and almost perfect safety.

Presently, loss off-sets may be charged against taxable income in a two

---

[1] George, Edwin B. and Landry, Robert J.,"The Shadow of '102' on Dividend Policy," Dun's Review Supplement.

year carry forward manner. This period is viewed as too short for small businesses, especially relatively new businesses that generally operate for two or three years before hitting a profit making period. Small enterprises have a much greater fluctuable income and as a result many times taxes fall partly on capital rather than exclusively on net income.

If more emphasis were placed on carry forwards this problem might be mitigated somewhat and less discrimination placed on those businesses with seriously fluctuating incomes and a lack of diversity with reference to output.

Depreciation: According to Regulations III, Section 24, 23 (1) - 1 of the Internal Revenue Code, depreciation must be spread over the whole useful life of depreciable property used within a trade or business.

Hearings held in Congress recently on the financial problems of small business pointed up rather closely that small firms are in great need of accelerated rates of depreciation. This was based on the fact that it would improve their position reference to accesibility of capital and would remove a tax deterrent to risk investment. It is not to be construed that the pattern of depreciation is now discriminatory and inequitable. Depreciation was chosen as one of the problems presented by the tax structure, through which relief could be brought to small enterprises without involving too much difficulty.

Accelerated depreciation would solve some but not all of the tax problems of small businesses. It would greatly help small businesses finance capital outlay in manufacturing and other industries in which relatively large amounts of depreciable assets are required. Risky and growing enterprises would be especially helped. As a means of removing tax deterrents to risky investments, accelerated depreciation would be more effective than a reduction in tax rates costing the same amount of revenue.

Tax differential on incorporated and unincorporated businesses: The major problem encountered in this brief analysis of the corporate profits tax is that of the double taxation feature whereby a tax is levied on distributed earnings and on undistributed earnings.

Under the present tax structure, earnings of incorporated businesses are subject to the corporation income tax, and dividend income of stockholders is subject to the regular individual income tax.[1] Earnings retained in the corporations for reasonable business purposes are subject only to the corporation income tax. In the cases of unincorporated enterprises, all earnings, whether reinvested in the business or withdrawn, are included in the income of the proprietor or partners and are subject to the regular individual income tax rate. From the point of view of small business the approach to this problem is through two methods.

One, the partnership method has often been proposed as a means of eliminating differences on unincorporated businesses. This would eliminate double taxation of distributed profits.[2]

Whether the partnership treatment would reduce current taxes on undistributed corporate profits would depend on the relationships between corporate tax rates and marginal tax rates of stockholders. Generally speaking, the partnership method would reduce taxes on undistributed profits

---

1 Federal Tax Course, "Classes of Tax Payers and Rate Structures," (Washington D. C.,1942), pp. 41 -46.

2 Op. cit., "Taxation of Small Business", p. 30.

of corporations owned by high-income stockholders. Under the present system, high-income stockholders derive at least a temporary tax advantage from retention of earnings in corporations. Retained earnings may be made a permanent part of a corporation's capital and never paid out in dividends. Although earnings are permanently retained in the corporation, the individual stockholder can realize on them by selling his stock. If he has held the stock longer than six months he is subject only to the low rate tax on long term capital gain.

The equity, economic and administrative considerations which have to be viewed under any contemplated tax change do not appear to be too difficult reference the application of the partnership method. However, one of determining eligibility for this method would prove inc nclusive and to some extent arbitrary. Viewed, however, as a tax relief device, the partnership method might be simplified enough to make it workable.

It seems unlikely that this method would greatly ease the financial problems of most growing small corporations, which ordinarily retain a large part of their profits. On the whole, it seems that the method would be most likely to be attractive to mature small corporations able and willing to pay out most of their profits as earned.

The individual income tax rate applicable to the income of proprietors or partners may reach a maximum of 85.5 per cent, whereas the retained earnings of corporations are subject to a maximum rate of thirty-eight per cent. For this reason, it is argued that the tax system makes growth from reinvested earnings harder for proprietorships and partnerships owned by persons with higher incomes than for corporations. The discriminatory aspect of this problem does not stand up under close scrutiny. There is no possibility of discrimination against an unincorporated business unless the income of the owners is subject to a marginal tax rate higher than the corporate rate applicable to a corporation with the same amount of income as the proprietorship or partnership. Individuals with surtax net incomes of less than $4,000 pay a lower marginal rate than corporations with net incomes of less than $20,000; and individuals with surtax net incomes of less than $20,000 pay a lower marginal rate than corporations with net incomes between $25,000 and $50,000.

Furthermore, even in cases where owners of unincorporated businesses pay tax rates on reinstated profits that are higher than the corporate rates, they may suffer no net tax disadvantage with respect to their whole business incomes. The individual tax is the only tax imposed on the portion of profits withdrawn from an unincorporated business, whereas distributed corporate profits are subject to both the corporation income tax and the individual income tax. This freedom from so-called double taxation of profits withdrawn from the business will in many cases counterbalance the effect of a higher tax rate on reinvested earnings even in the case of proprietorships and partnerships owned by individuals with large incomes.

From positions of equity, economic and administrative consideration alleviation of this problem would not be difficult and it is doubtful if its incidence upon investment is important.

Attempts to specifically alleviate any special point in the tax structure as long as they pertain to small business will generally run into serious problems of equity, economic and administrative consideration. However, it is appropriate to examine the tax system to determine to what extent tax revisions may properly be used to further the national policy with respect to small businesses.

CHAPTER IV

SUMMARY AND CONCLUSION

Since the present tax system tends to increase the risk of small business much more than that of large businesses, this constructive analysis seeks to improve the prospects and strengthen the relative position of small business.

It is only through objective analysis of the problems which the present tax system brings to bear upon small businesses that we can arrive at a tax structure designed for the benefit of the entire economic system instead of just a major segment.

The most important condition to the prosperity of all businesses, small and large, is an economic system operating at high and rising levels of production. For this reason the most important contribution that the tax system can make to the healthy growth of small as well as large business is through general measures that improve the equity of the present system and minimize any adverse effects on investments and consumer demand.

The gain to be realized by small business from a tax system which promotes high-level production far surpasses any advantage to be derived from special tax revisions designed specifically in the interests of small businesses. Well conceived general tax revisions would also avoid the undesirable collateral economic-effects that might be associated with many of the special measures that have been advanced for the benefit of small business.

Despite the preeminent importance of general tax revisions, it may be desirable to give consideration to the special points of the tax structure which seem to press more burdensomely upon small enterprises than large ones, guided at all times by the objectives of a good tax system, namely, to provide sufficient revenue for governmental expenditures and reduction of our national debt, to encourage employment and stimulate competition.

These points are as follows:

1. Rates on corporate and individual income are too high.
    a. Corporate tax-rates are too limited in the notch area.
    b. Section 102 of the Internal Revenue Code needs modification.
    c. Loss-offsets are too limited.
    d. Depreciation needs acceleration.
2. Differential of taxes on corporate and unincorporate businesses.

TABLE I

IMPORTANCE OF SMALL ESTABLISHMENTS IN SELECTED INDUSTRY GROUPS 1939

(Money Figures in Thousands)

Industry Group	Number of Establishments			Number of Personnel **1		
	U.S. Total	Small Business	Per Cent Small Business	U.S. Total	Small Business	Per Cent Small Business
Manufacturing	184,730	168,814	91.6	7,886,567	2,358,968	29.9
Wholesale Trade	92,794	71,681	77.2	912,795	355,731	39.0
Retail Trade	1,770,355	1,614,310	91.2	6,213,890	3,487,984	56.1
Service	646,028	637,585	98.7	1,754,538	1,294,724	73.8
Hotels	27,987	25,224	90.1	362,047	11,183	30.7
Construction	215,050	200,299	93.1	1,300,439	**2	30.2 ** 2
Amusement	44,917	40,351	89.9	257,200	145,641	56.6
Total	2,981,361	2,758,264	92.5	18,687,476	7,754,231	41.5

Source: Department of Commerce, Bureau, Sixteenth Census of the United States, Census of Business.

**1 Including Self Employed except in Manufacturing
Number of Employees plus number of Active Proprietors

**2 Number of Personnel not available. Percentage figure based on payroll breakdown.

TABLE 1 (Cont'd)

IMPORTANCE OF SMALL ESTABLISHMENTS IN SELECTED INDUSTRY GROUPS 1939

(Money Figures in Thousands)

Industry Group	Value of Output or Sale		
	U. S. Total	Small Business	Percent Small Business
Manufacturing	$56,843,025	$17,366,690	30.6
Whole Sale Trade	19,418,547	4,100,404	21.1
Retail Trade	42,041,790	17,836,171	42.4
Service	3,420,417	2,241,709	65.5
Hotels	836,155	229,163	26.6
Construction	4,519,794	1,546,275	34.2
Amusement	998,079	332,837	33.4
Total	$ 128,104,807	$ 43,653,257	34.1

Source: Department of Commerce, Bureau, Sixteenth Census of the United States, Census of Business.

INCOMES OF ALL CORPORATIONS, 1916-1942

Table 2

	Number of Returns				
Year	Total Active	Net Income	No Net Income	Per Cent No Net To Total	Per Cent Average 1916 to 1919
1916	341,253	206,984	134,269	39.4	38.1
1917	351,426	232,079	119,347	34.0	
1918	317,579	202,061	115,518	36.5	
1919	320,198	209,634	110,564	34.4	
1920	345,595	203,233	142,362	41.2	
1921	356,397	171,239	185,158	51.9	
1922	382,883	212,535	170,348	44.4	
1923	398,933	233,339	165,594	41.5	Per Cent
1924	417,421	236,389	191,032	43.4	Average
1925	420,072	252,334	177,738	41.3	1920 to 1929
1926	455,320	258,134	197,186	43.3	42.6
1927	425,675	259,849	165,594	38.7	
1928	443,611	268,783	174,828	39.4	
1929	456,021	269,430	186,591	41.0	
1930	463,036	221,420	241,616	52.2	
1931	459,704	175,898	283,806	61.7	
1932	451,884	82,646	369,239	81.6	Per Cent
1933	448,842	109,786	337,056	75.5	Average
1934	469,804	145,101	324,703	69.4	1930 to 1939
1935	477,113	164,231	312,882	65.5	64.5
1936	478,857	203,161	275,696	57.7	
1937	477,838	192,028	285,810	60.0	Average
1938	471,032	169,884	301,148	64.0	1936 to 1939
1939	469,617	199,479	270,138	57.5	59.8
1940	473,042	220,977	252,065	53.7	Per Cent
1941	468,906	264,628	204,278	43.0	Average
1942	442,665	269,942	172,723	39.1	1940 to 1942
					45.3

Source: Bureau of Internal Revenue, Washington, D.C. 1942

TABLE 3

CASH POSITION OF 383,534 CORPORATIONS WHICH FILED BALANCE SHEET MATERIAL WITH THEIR TAX RETURNS, 1942

1942 Asset Class	Number of Firms	Gross Income (millions)	Net Income (millions)	Percent Net to Gross	Taxes Paid (millions)	Net After Taxes	Percent Net After Tax To Gross
Under....$ 50,000	196,642	$ 9,139	$131	1.4	$ 82	$ 49	.5
$50,000 - 100,000	58,338	7,494	270	3.6	123	147	1.9
100,000 - 250,000	57,365	14,252	729	5.1	367	362	2.5
250,000 - 500,000	27,300	13,306	890	6.7	500	390	2.9
Under.....500,000	339,645	44,191	2,020	4.6	1,072	948	2.1
Over..... 500,000	43,889	160,789	20,927	13.0	11,066	9,861	6.1
TOTAL	383,534	204,980	22,947	11.2	12,138	10,809	5.3

SOURCE: Bureau of Internal Revenue, Washington, D. C., 1942.

TABLE 4

AVERAGE INTEREST RATES ON SHORT AND LONG TERM BUSINESS LOANS AT MEMBER BANKS, BY SIZE OF BORROWER, November 20, 1946

ASSETS OF BORROWERS (thousands of dollars)	SHORT TERM[1] (percent per annum)	LONG TERM[2] (percent per annum)
Under.....50	5.1	5.4
50.......250	4.2	4.4
250.......750	3.4	4.0
750......5000	2.7	3.2
5000 and over	1.7	2.1
All Borrowers[3]	3.0	2.8

1 Maturity of one year or less.

2 Maturity of more than one year.

3 Includes rates paid on a small amount of loans unclassified by size of borrowers.

SOURCE: Federal Reserve Bulletin, July, 1947, pp. 816.

TABLE 5

EXCESS RESERVES AND CAPITAL RESERVES OF COMMERCIAL BANKS
1939 - 1944

	1939	1940	1941	1942	1943	1944
Excess reserves of Member Banks, end-of-month figures - 4th Quarter. (In millions of dollars)........	$5,209	$6,615	$3,085	$1,988	$1,226	$1,773
Insured Commercial Banks,[1] Total Capital Accounts as percentage of total assets, as of December 21, (Aggregate figures)......................	10.3%	9.5%	8.9%	7.4%	6.7%	6.3%
Total Capital Accounts as percentage of Loans, Discounts and Securities, other than Governments, as of December 31, (Aggregate figures)...........	27.8%	26.8%	24.0%	27.8%	30.2%	28.7%

[1] Assets and Liabilities of operating Insured Bonds, Report #14, p. 3, Report #18, p. 3, Report #21, p. 3, (June 30, 1944), Federal Deposit Insurance Corporation.

SOURCE: Banking and Money Statistics, Board of Governor of the Federal Reserve System (Washington, D. C.,1943), Table #102, pp. 377; Federal Reserve Bulletin (April 1944), p, 353, and (February 1945), p. 139.

TABLE 6

CORPORATIONS WITH NET INCOME - CLASSIFIED BY SIZE OF NET INCOME, 1942

Net Income Class (Thousands)	Number of Returns[1]		Net Income[2]	
	Number	Percent Of Total	Amount (Thousands)	Percent Of Total
0 ---- $ 5	150,095	55.6	238,585	1.0
$ 5 ---- 10	35,424	13.1	253,671	1.1
10 ---- 15	17,163	6.3	210,610	.9
15 ---- 20	10,523	3.9	182,621	.8
20 ---- 25	7,455	2.8	167,082	.7
25 ---- 50	17,465	6.5	615,433	2.5
50 and Over	31,817	11.8	23,384.357	93.0
All Classes	269,942	100.0	24,052,359	100.0

1
With Net Income.

2
Net Income is the amount reported for declared value, excess profits tax computation adjusted by excluding net operating loss deduction.

SOURCE: Statistics of Income for 1942.

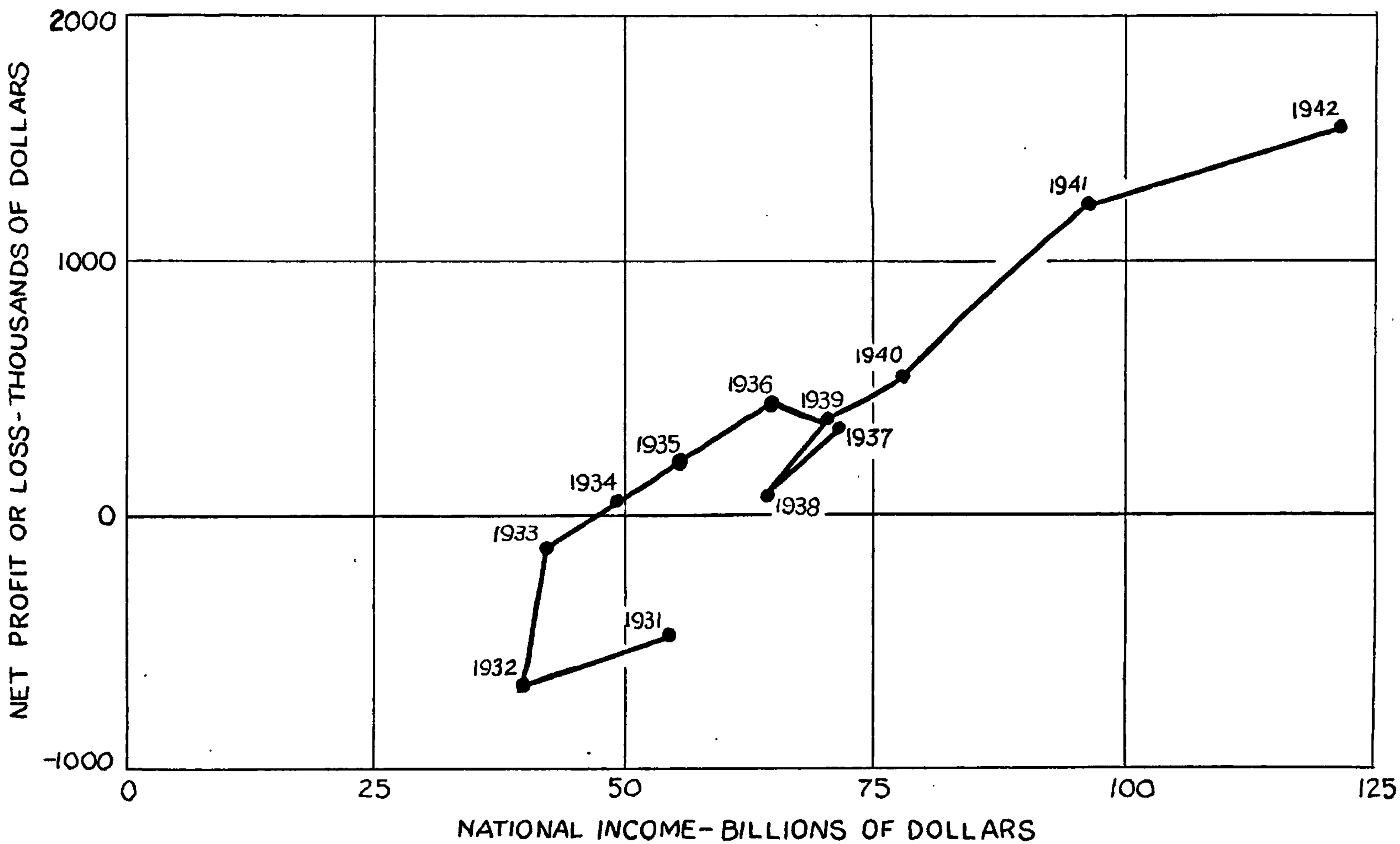
TABLE 7

TERM LOANS OF MEMBER BANKS TO BUSINESS, NOVEMBER 20, 1946, BY BUSINESS AND SIZE OF BORROWER

BUSINESS OF BORROWER	ALL BUSINESSES	SIZE OF BORROWER (Total assets in Thousands of Dollars)				
		Under 50	50 to 250	250 to 750	750 to 5,000	5,000 and over
	(Amount of term loans in millions of dollars)					
RETAIL TRADE	$ 404	$142	$ 82	$ 31	$ 21	$ 128
WHOLESALE TRADE	223	22	48	26	36	91
MANUFACTURING AND MINING	2,367	45	95	95	308	1,824
PUBLIC UTILITIES	939	37	33	31	70	768
SERVICE	229	63	52	16	30	69
ALL OTHER	325	45	79	38	57	107
ALL TERM BORROWERS	$4,487	$354	$388	$237	$522	$2,987

SOURCE: Business Loans of Member Banks, Federal Reserve System, November 20, 1946, p. 17.

SMALLER MANUFACTURING CORPORATIONS
NET PROFIT OR LOSS RELATED TO NATIONAL INCOME
1931-1942

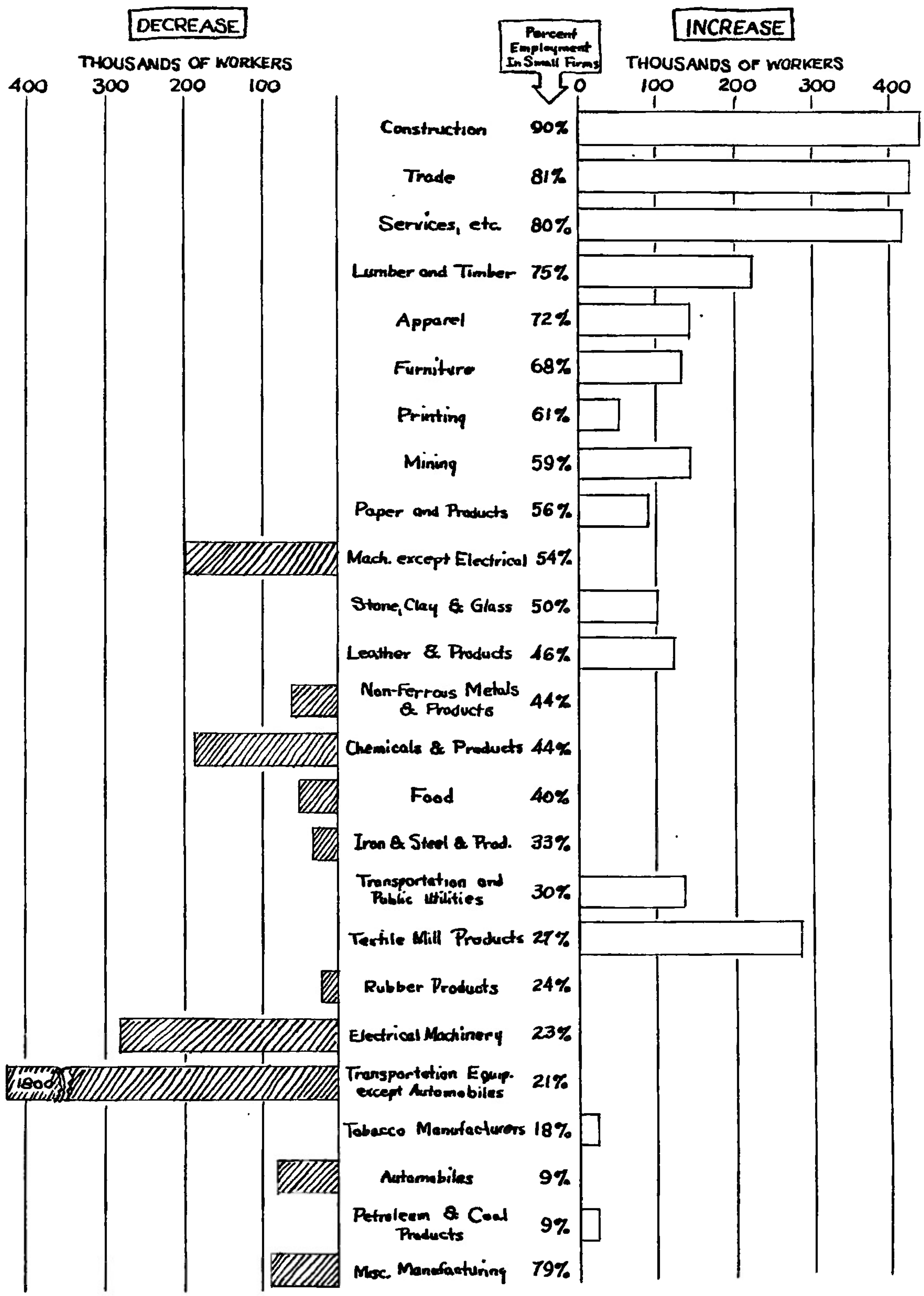


Source: "Survey of Current Business, April, 1944 and February 1945," Department of Commerce

NON-AGRICULTURAL INDUSTRIES

ESTIMATED EMPLOYMENT CHANGE IF 55 MILLION WORKERS WERE TO BE EMPLOYED IN 1947

1944-1947



Source: U.S. Bureau of Labor Statistics (Preliminary) Unpublished. Estimates subject to substantial revision.

BIBLIOGRAPHY

PART I

Books

Abbot, Charles C., Financing Business During the Transition, Committee for Economic Development Research Study. New York,1946.

Jacoby, Neah H., and Saulnier, Raymond, J. Term Lending to Business, National Bureau of Economic Research. New York: 1943.

Jacoby, Neah H., and Saulnier, Raymond, J. Accounts Receivable - Financing, National Bureau of Economic Research. New York: 1943.

Leonard , R. F. Supervision of the Commercial Banking System, in Banking Studies. Washington, D. C.

Oxenfeldt, Alfred C. New Firms and Free Enterprise, American Council on Public Affairs. Washington, D. C. 1943.

Pamphlets

Credit Sources For Small Businesses, Department of Commerce. Washington, D. C.,1945.

Census of Business, Department of Commerce. Washington, D. C.,1939.

Reports and Statements

Progress Reports of Senate Small Business Committee, 1945, 79th Congress, 1st Seddion.

What About Small Businesses? A Statement Presented to The House Ways and Means Committee by National Tool and Die Manufacturers Association in Cooperation with Other Tool and Die Manufacturers, 1943.

Viner, Jacob and Hardy, Charles O., Summary of Findings as to Facts. Report on the Availability of Bank Credit in the Seventh Federal Reserve District.

Annual Report of the Federal Deposit Insurance Corporation for the Year ending December 31, 1942.

Survey of Reports of Credit and Credit Difficulties. Department of Commerce, Washington, D. C., 1935.

Statistics of Income of all Corporations, Bureau of Internal Revenue, Washington, D. C. 1942.

A Program for Prosperity in a Free Economy, A Statement on National Policy, The Research and Policy Committee of the Committee for Economic Development, 1947.

Bulletins

Federal Reserve Survey of Business Loans, November 20,1946.

Federal Reserve Bulletin, April, 1948

PART II

Books

George, Edwin B., and Landry, Robert, J. "The Shadow of '102' on Divident Policy," Dun's Review Supplement, 1947.

Journals

"Corporate Earnings by Size of Firm," Survey of Current Business, May 1945.

Proceedings of the Academy of Political Science, Vol. XXII, May 1947, # 3.

Reports

Taxes and the Budget,Committee for Economic Development, November 1947.

Tax Program for a Solvent America, Committee Postwar Tax Policy,1947.

Smaller War Plants Corporation, Economic Report on Taxation, September, 1945.

"Taxation of Small Business", Treasury Department. Washington, D. C., October 1947.

Federal Tax Course, Commercial Clearing House, 1942.